This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Fiscal Policy and Management in East Asia, NBER-EASE, Volume 16

Volume Author/Editor: Takatoshi Ito and Andrew K. Rose, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 978-0-226-38681-2

Volume URL: http://www.nber.org/books/ito_07-1

Conference Date: June 23-25, 2005

Publication Date: October 2007

Title: Comment on "Australian Government Balance Sheet Management"

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URL: http://www.nber.org/chapters/c0893

Comment   Corrinne Ho

This paper deals with the question of how best to structure the government's balance sheet (i.e., the mix of assets and liabilities) in order to safeguard against contingent risks. The paper approaches this timely question for the case of Australia by applying the Bohn (1990) model to data from the floating exchange rate regime period (1983 Q4 to 2004 Q3).

Bohn's model is basically an optimization problem in which the government chooses the tax rate and portfolio mix to maximize the utility of the individual, subject to the usual intertemporal budget constraints. A key feature here is the assumption that changes in the tax rate are distortionary, thus resulting in the preference for tax smoothing. Accordingly, the model suggests that the optimal government portfolio depends on the covariances between the innovations in returns and those in output (and, in principle, government spending). The main empirical findings are:

- There are more demand shocks than supply shocks in the sample period, suggesting it is optimal for the government portfolio to be net long on domestic nominal bonds.
- When given a choice of both domestic and foreign debt securities, there is some scope to be net long in foreign securities.
- When given a choice of debt securities (domestic) and equities (domestic and foreign), domestic equities are found to provide no hedge against output shocks, as expected, and there is some scope to be net long in foreign equities.

In short, there is evidence to support portfolio diversification across currencies and asset classes, at least based on past macro data and returns of the set of assets included.

As with most policy-oriented research work, this paper faces some usual—though not insurmountable—challenges. For instance, the validity of some technical details or assumptions (e.g., tax smoothing) of Bohn's model may be subject to debate. I shall not hold the authors responsible for Bohn's model, but I would suggest that they could preempt such criticisms by clearly stating up front that their paper is only a straight application of Bohn (1990). As it stands, the paper seems to sound like it is developing its own framework that is *drawn on* Bohn (1990). But anyone who has read the original Bohn article would have noticed that the model is actually the same. Perhaps it is only a matter of drafting, but *truth in advertising* could help limit the authors' liability.

That said, however, I do want to hold the authors accountable for their choice of this particular model to address Australia's particular problem

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and their presentation thereof. On choice, it is not immediately clear from the text why the Bohn (1990) model straight out of the box is the best tool for analysis. Perhaps the rationale is obvious for people who are familiar with the literature, but not necessarily so for others. It would be useful if the authors could briefly explain and defend their choice in section 7.3.1, at least for the benefit of those readers who are not experts in this field. And, not to mention, it could make the paper more authoritative and convincing.

On presentation, I sense a kind of *mismatch* or *disconnect* between the rich institutional background in section 7.2 and the more abstract analytics in section 7.3. Bohn's article, which features exactly the same analytical framework, does not have this *disconnect* because its introductory section is relatively brief. This allows the paper to get to the *main feature* (the model) quickly. The reader can thus focus squarely on the theoretical and empirical analyses and take them for their own worth. So, while Bohn's article may not be as rich in institutional background, it has a cleaner presentation that ultimately makes for more satisfying reading. For the present paper, I would suggest tightening up the connection between sections 7.2 and 7.3 by cutting down on (or moving to footnotes) those details and diversions that slow down the flow from background to analytics, and by making more cross references throughout the text to link Australia's situation to the model and vice versa. This should help to keep the reader's train of thought on track from the first page to the last.

Finally, beyond the immediate confines of the present paper, I see potential for extensions and further research. Perhaps one can ask if there are any modifications one can make to Bohn (1990), which deals with a (U.S. case-inspired) generic government debt structure problem, to make it more specific to the current Australian situation. For instance, the authors mention the government's conscious effort to maintain a certain stock of government bonds—can this and other potential portfolio choice constraints be built into the model to make it more Australia-specific? Alternatively, can Australia's government balance sheet management problem be addressed by other models or approaches? Further afield, perhaps one can investigate the political economy of government asset and liability management, or the implications of reform for fiscal policy, monetary policy, and the financial markets. It could also be interesting to consider what similarities and difference there are between the government's portfolio choice problem and the central bank's reserve management problem. The possibilities are vast, and this paper is a good start.

Reference

Bohn, H. 1990. Tax smoothing with financial instruments. *The American Economic Review* 80 (5): 1217–30.